



## **California Tax Reform Association**

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### **Testimony presented to the California Performance Review panel, relative to Tax Commission and Tax Policy recommendations, September 27, 2004, UC Davis**

By Lenny Goldberg

Thank you so much for permitting me to contribute to this process.

I want to note that I met twice with members of the Performance Review team, at their invitation, once on tax issues and the other on the organization of the victims' program. However, my name was not included as someone consulted by your effort. But I was consulted, and I appreciate it.

In my oral testimony, I will focus on 1. governance and key principals to keep in mind when reforming or changing governance; 2. functions, in particular the appellate process and the separation of executive, regulatory and judicial functions, and 3. some comments on one other tax issue raised in the CPR report.

I have been involved in legislation and discussions of reorganization proposals and issues about the functionality of our tax system for at least the last 15 years, on behalf of the California Tax Reform Association. I was involved in the legislation when Governor Wilson vetoed a bill to consolidate the FTB under the BOE, and also when he proposed consolidation under a Department of Revenue. I have worked on a number of reform proposals for the BOE and the FTB with regard to open meetings, procedures and governance, tax adjudication, taxpayer-friendly proposals such as e-filing and taxpayer privacy, and, to the sometime dismay of the FTB, in non-tax collection including child support and court-ordered debt.

#### **1. Current governance**

a. The FTB: If it ain't broke, don't fix it. My view of the FTB is that it is exemplary in its efficiency and has strived, under the leadership of various controllers, to be as taxpayer-friendly as possible. The CPR report acknowledges that in a variety of ways, noting, for example, FTB's leadership in technology among its various strengths.

I would attribute this success in part to its hybrid and perhaps odd structure, which has provided for a successful mix of policy control by elected officials and of independence of administration. Important FTB policies are decided by elected officials, not tax administrators, but those elected officials—the Governor, the Controller, and the Chair of the BOE—have other obligations, and, with some exceptions, have left administration to the administrators. Tax administration stretching back to before the current administration was notable for its independence from the swings of politics. In no other

arena of government have you had the longevity and consistency of administration that the FTB has had, with demonstrably successful results.

This runs counter to many views, and even my own as I have thought about it before, that the hybrid structure may be a reason it has been so successful. That is, the diversity of elected officials on the board has made for consistency of administration, while the elected officials still determine the policy, which provides the clear separation necessary to successful independent tax administration. Thus, while there may be no logic to its governance, it is in fact effective.

b. The BOE: Confusion of functions, hydra-headed administration. The Board of Equalization has not, by many estimations, been an efficiently-run agency. Its job is nowhere near as difficult as that of the FTB, for several reasons: it has none of the conceptual difficulty inherent in the complexity of income and profit determinations, although the sales tax has many borderline regulatory issues. And, it does not have to deal directly with approximately 15 million filers. Rather, its direct responsibilities are for a little over 1 million sales tax payers, a small number of utilities and railroads which are state-assessed and a number of fee-related programs, with a limited number of taxpayers. Yet by a number of indicators, including particularly its level of technology, it has not had the administrative consistency of the FTB over the years.

The BOE structure is also highly unusual: nowhere in the country is there an elected tax board, with full-time members, let alone one whose role encompasses executive, legislative and judicial functions. I believe that this confusion of roles and lack of clear administrative leadership has led to politicized and ineffective administration, policy, and adjudication. If nothing else comes from this effort, this commission should recommend the separation of appellate functions from executive and regulatory ones. I elaborate on that below.

2. CPR proposal: in need of greater clarity. The CPR proposal makes a critically important point, but fails to explain how it would be implemented. That critical point is that the Governor—i.e. the Administration—must have a role in the administration and policies of the tax system. Currently, they have that role with the FTB, both through Finance membership on the FTB and through the State and Consumer Services Agency. The CPR proposal suggests a Commission “under” the Governor, but no clarity as to how that would happen.

Otherwise, it appears that the BOE becomes the Tax Commission, without gubernatorial participation. I ask you to leave all political considerations aside, and answer this question: under current circumstances, which organization—the FTB or the BOE—is more efficient, better run, and more responsive to taxpayers. If the answer is the FTB—and it must be—then it is very hard to justify the wholesale reorganization of the system with a governance structure that has had worse, rather than better, results.

### 3. Principles of reform:

a. The Governor must have a role in the governance of the tax system. The Administration has a preponderance of power in the budget process, from proposing the budget, to controlling most of the information from departments and agencies through the Department of Finance, through the blue-pencil power in the final budget. Since the vast majority of those expenditures come from tax programs, the Administration must have responsibility and involvement in the operation of the tax side of the equatin. They cannot be abdicated to separately elected officials such that the governor has no responsibilities or power whatsoever.

b. There must be independence of tax administration. Despite every effort to avoid it, political favoritism can potentially be involved in tax administration, particularly when millions of dollars are at stake. Whether ultimately there is a tax commission or a department of revenue, the chief executive officer, and the staff, should be shielded from political pressure. Thus, if there is consolidation, we would support a long term of office for the CEO, approved by the Senate, staggered from any Governor's term, with removal by the Senate for cause, for someone with tax administration qualifications.

c. Beware false economies. Nowhere in the CPR report is there clarity as to where the savings are going to come from. Arguably, consolidation of cashiering functions and technology can yield savings, and the LAO is studying that right now. However, auditing is highly technical, and sales tax and income tax auditing are very different. So it's likely that there will be short-term costs to consolidation, particularly in technology, and the benefits may or may not be compelling. Blowing up boxes for its own sake does not necessarily yield benefits.

d. Tax adjudication must be separate from regulation and administration. And, it must be reformed in either the current context or under any consolidated structure. I'll elaborate below.

### 4. Alternate structures. Is there a particular governance structure which maintains the integrity, efficiency and independence of tax administration currently demonstrated by the FTB, which could be broadened to get similar results with the other tax agencies?

There are a number of options which can build upon the current structure, which includes officials who are elected for no other purpose than tax purposes (the BOE), and other officials whose role only partially includes tax functions.

One is a broadened unified tax commission, including BOE members and the Governor, Controller and Treasurer. Such a commission could set policy and oversee the administration of the tax system. The BOE separately could continue to do their constitutionally determined property tax functions, in the absence of a constitutional amendment. BOE members, as elected tax officials, would still be the direct point of access to the system for ordinary taxpayers. As mentioned above, independence of tax administration can be assured through term appointments and removal for cause.

I make this recommendation tentatively, because it is very difficult to know in advance what structures lead to better or worse performance. Its weakness is that the authority of the Administration is somewhat limited. On the other hand, the likelihood that independent tax administration would be maintained by this proposal is high, because politicization is difficult to do with a broader commission. There are many other options, but many have limited political viability, given the current structure.

5. Adjudication. Much has been written about the problems of adjudication in California. Briefly:

- the administrative and policy-setting agency should not sit in judgment on their own administration and policy—a violation of separation of powers principles.

- elected officials who take campaign contributions should not sit in judgment of taxpayers who contributed—and there are both loopholes in the recusal process and problems with the recusal process itself.

- continued ex parte communications violate principles of even-handed administration of justice, but arguably restrictions on such communications run counter to the requirement that elected officials communicate with their constituents.

- there is little in the way of established law and precedent which comes out of BOE decisions, heightening taxpayer uncertainty and giving the appearance, if not the reality, of arbitrary decision-making.

- the FTB cannot appeal an adverse decision, while the taxpayer has to pay the tax first in order to get their day in court.

- the average time for a tax appeal is about 20 minutes, not sufficient for complex cases, or even necessarily for small taxpayers.

The solution, of course, is a tax court, made all the more necessary if consolidation of tax governance is going to take place. The precedent of the IRS tax court, separate from the Treasury, is a good one, for practitioners, taxpayers and the government alike. Such a court would:

- have substantial tax expertise

- would be independent of the taxpayer and the tax collection agency

- would establish precedent for interpretation of the law

- would allow taxpayers a sufficient day in court without paying their tax first

- would provide equal access of the taxpayer and the tax agency to the appellate level

- would provide substantial time for hearings

- would have a simplified small claims process for small taxpayers.

6. CPR recommendation relative to sales tax credit on manufacturing. Two comments:

- a. There is no basis for an estimation of revenue gain. The DOF dynamic model shows at best an 18% feedback on business tax reductions, for many reasons.

- b. There are clearly inefficiencies in the way we tax business. Specifically, we tax manufacturing equipment twice, while not taxing windfall land rents at all. That is,

we tax new investment but don't tax the benefits which accrue from the investment of others—precisely the wrong way to tax.

This is a longer conversation, clearly, and I suggest you urge examination of these issues by the Governor's Jobs and Economic Growth Commission and/or the Council of Economic Advisors, with the proviso that they hear from broad-based points of view, and in particular include examination of the property tax as well as sales and income taxes in their analysis.

Finally, on an unrelated issue (but related to government reorganization), I have had extensive involvement with the Victim Restitution program, on behalf of child abuse treatment agencies. I think the consolidation recommendations of the CPR report are correct and are without controversy, and should move forward as quickly as possible.